The US Sunnyslope–case: a slippery slope for creditors?

Valuation in cramdown procedures: creditors be damned?

The facts of the case

The debtor, Sunnyslope Housing Limited Partnership ("Sunnyslope"), developed and operated an apartment complex intended to provide affordable housing. When Sunnyslope defaulted on the senior loan for the project, the Department of Housing and Urban Development honored its guarantee, acquired the senior loan from the original private lender, and resold it to First Southern National Bank. First Southern started the foreclosure process, which would have wiped out affordable housing restrictive covenants related to additional financing. The debtor then was put into bankruptcy, and it exercised the cramdown option of 11 U.S.C. § 1325(a)(5)(B) and elected to retain the property in exchange for a new payment plan that would require it to pay First Southern an amount equal to the present value of the secured claim at the time of bankruptcy.

Sunnyslope argued that the value of First Southern's secured interest should be calculated with the affordable housing restrictions remaining in place. The bankruptcy court and the district court both agreed. Later on, a divided panel of the Ninth Circuit reversed the court's order approving the plan of reorganization, holding that the court should have valued the apartment complex without regard to the affordable housing requirements that restricted use and, in turn, lowered value. Subsequently, the Ninth Circuit granted Sunnyslope's petition for rehearing en banc.

The opinion of the court

In this atypical case, the "going concern" use results in a lower value than a market foreclosure value (due to the potential for First Southern in foreclosure to invalidate the restrictive covenants). Consequently, the central issue on rehearing was whether the bankruptcy court erred by valuing the apartment complex assuming its continued use after reorganization as low-income housing. Reversing the three-judge panel, the en banc court held that the district court did not err in applying the lower value.

The en banc court based its opinion on the Supreme Court's decision in *Assocs. Commercial Corp. v. Rash,* 520 U.S. 953 (1997), which stressed the instruction in § 506(a)(1) to value the collateral based on its "proposed disposition or use" in the plan of reorganization. The Supreme Court in *Rash* emphasized that, in a reorganization involving a cramdown, the debtor will continue to use the collateral. A valuation must therefore occur in light of the "proposed repayment plan reality" and not on a "hypothetical foreclosure sale". Since the "actual use" of the property is low income-housing and not a foreclosure sale (which is being avoided by the bankruptcy plan), the – value-decreasing – restrictive covenants stay in place.

Creditors be damned?

In a dissenting opinion, judge Kozinski, joined by judges O'Scannlain and Friedland, points out that the opinion of the court "fetishizes a selection of the Court's words at the expense of its logic". The court relies on a strict "particular use" interpretation of "replacement value". The dissidents, however, are not found of that interpretation. According to them, *Rash* was unambiguously motivated by a desire to reduce what it saw as the "double risks" that cramdowns pose for creditors: "the debtor may again default and the property may deteriorate from extended use". The typically higher secured-creditor-friendly-replacement-value standard over the typically lower foreclosure-value standard gives the secured creditors their due protection. According to the dissidents, the opinion of the court is the result of cramped formalism. The new valuation standard – holding the valuation hostage to the debtor's "particular use" – turns entirely on the debtor's desires; creditors be damned. After all, the foreclosure value is in this case greater than the replacement value.

Furthermore, if we acknowledge that a cramdown procedure is a forced sale from the company to the creditors (T.H. JACKSON, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain", *Yale Law Journal* 1982, (857) 893), we should be reluctant to let the seller dictate the price. After all, First Southern bought the senior loan, expecting that if the company entered financial distress, it would be able to start the foreclosure process, which would have wiped out the restrictive covenants, and in turn, increased value. If Sunnyslope wants to reorganize its business, it has to "buy" the claim from First Southern. It speaks for itself that First Southern would not have sold the claim to Sunnyslope for less than the market foreclosure value, since the market foreclosure value was greater than the "going concern" value. Indeed, in my opinion, a reorganization procedure should always make creditors better off. This is consistent with the ex-ante hypothetical creditors bargain theory (T.H. JACKSON, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain", *Yale Law Journal* 1982, (857) 860; D. G. BAIRD en T.H. JACKSON, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy", *University of Chicago Law Review* 1984, (97) 100) and the no creditor worse off principle which can be found in article 34(g) of the Directive 2014/59/EU of 15 May 2014 concerning the recovery and resolution of credit institutions and investment banks, article 22(c) of the European Commission's recommendation of 12 March 2014 on a new approach to business failure and insolvency and recital 27 of the Proposal for Directive 2016/0359 concerning preventive restructuring frameworks, second change and measures to increase the efficiency of restructuring, insolvency and discharge procedures amending Directive 2012/30/EU.

However, let us put this judgement into perspective. Firstly, reorganization procedures will more often than not increase the value of the company – and thus increase the value of creditors' claims. Secondly, creditors such as First Southern – which are voluntary sophisticated creditors with a lot of bargaining power – will pass much of the risk on to the borrowers in the form of higher interest rates. As a result, these creditors will rarely be damned after all.

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